

# Oklahoma Law Review

---

Volume 44 | Number 4

---

1-1-1991

## Securities: Is "Any Note" Really a "Security"? Supreme Court Says "No" in *Reves*

John Scribner

Follow this and additional works at: <https://digitalcommons.law.ou.edu/olr>



Part of the [Securities Law Commons](#)

---

### Recommended Citation

John Scribner, *Securities: Is "Any Note" Really a "Security"? Supreme Court Says "No" in Reves*, 44 OKLA. L. REV. 765 (1991),  
<https://digitalcommons.law.ou.edu/olr/vol44/iss4/10>

This Note is brought to you for free and open access by University of Oklahoma College of Law Digital Commons. It has been accepted for inclusion in Oklahoma Law Review by an authorized editor of University of Oklahoma College of Law Digital Commons. For more information, please contact [darinfox@ou.edu](mailto:darinfox@ou.edu).

# Securities: Is “Any Note” Really a “Security”?

## Supreme Court Says “No” in *Reves*

### I. Introduction

The Securities Act of 1933 and the Securities Exchange Act of 1934 (collectively, the Securities Acts) begin their definition of a security with the term “any note.”<sup>1</sup> A literal reading of the statute might lead one to believe that any promissory note is a security regardless of the circumstances giving rise to its generation. Thus, any promissory note would come within the purview of the Securities Acts.

From a conceptual point of view, treating all promissory notes as securities raises no particular problems with the registration requirements under the Securities Acts. The original issuance can normally fall within the private placement exemption found in section 4(2) of the 1933 Act.<sup>2</sup> Problems arise, however, with the application of the anti-fraud provisions to consumer or commercial transactions involving promissory notes. Is the promissory note given by a consumer in the purchase of a car, refrigerator, or house to be used by the purchaser for his own private use, a security? Likewise, is the promissory note given to a bank as evidence of the loan made to a small business to buy needed equipment or supplies a security?

If so, persons giving such notes should be entitled to avoid the transaction under Rule 10b-5<sup>3</sup> when they discover the item was fraudulently represented

1. Section 2(1) of the Securities Act of 1933 states:

When used in this subchapter, unless the context otherwise requires — the term “security” means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificates of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a “security,” or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

Securities Act of 1933, § 2(1), 15 U.S.C. § 77b(1) (1988) [hereinafter the 1933 Act]. The definition of “security” in the Securities Exchange Act is slightly different. In spite of occasional differences in wording, the definitions of “security” in the two Acts are functionally equivalent. Securities Exchange Act of 1934, § 3(a)10, 15 U.S.C. § 78c(a)10 (1988) [hereinafter the 1934 Act]. Both the Senate Report and the Supreme Court have recognized this. See S. REP. NO. 792, 73d Cong., 2d Sess. 14 (1934) (“substantially the same”); *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967) (“virtually identical”).

2. 15 U.S.C. § 77d(2) (1988). The private placement exemption allows an issuer to sell unregistered securities to sophisticated investors who are wealthy enough to withstand the loss of their original investment.

3. See 17 C.F.R. § 240.10b-5 (1972) [hereinafter Rule 10b-5], promulgated under the 1934

to them. Similarly, the seller would have a cause of action under section 12(2) of the 1933 Act if the purchaser misrepresented his financial condition or ability to pay.<sup>4</sup>

The first section of this note will examine how the courts have dealt with the "any note" language as a "security" issue. The early cases applied a plain meaning, literal language approach to statutory interpretation. Under this approach, all notes would be treated as securities.

Later, the courts backed away from this literal reading on the grounds that such an approach extends the scope of the federal acts beyond that which Congress could have reasonably intended. This more restrictive approach created a wide divergence among the courts of appeals regarding what tests should be applied for determining when promissory notes are securities. The United States Supreme Court attempted to resolve this confusion with its recent holding in *Reves v. Ernst & Young*.<sup>5</sup> The second part of this note will analyze *Reves* and its progeny.

## II. The Early Cases

As noted above, most of the early cases which dealt with the issue applied the plain meaning test and found that all notes were securities.<sup>6</sup> The case of *Lehigh Valley Trust Co. v. Central National Bank of Jacksonville*,<sup>7</sup> is a good example of these early cases. In *Lehigh Valley*, one bank sold a participation interest in a loan originated by that bank to another bank.<sup>8</sup> When the loan became uncollectible, the purchaser-bank sued the seller-bank under Rule 10b-5 for failure to make a full and accurate disclosure of all material facts relevant to the participation.

The court analyzed the transaction under the "note" category in the definition of a "security" because the borrower gave the seller-bank his note in exchange for the loan. The seller-bank argued that the 1934 Act

---

Act, 15 U.S.C. § 78j(b) (1988). Rule 10b-5 makes it unlawful for any person to (a) employ any device, scheme, or artifice to defraud or (b) make any untrue statement of material fact or to omit to state a material fact or (c) engage in any act which would operate as a fraud upon any person. These acts are unlawful if done in connection with the purchase or sale of a security.

4. 15 U.S.C. § 77e(2) (1988). Remedies available under the federal securities laws are generally more attractive than those available under state securities laws. However, the applicable statute of limitations may be more attractive under state law. See Sonnenschein, *Federal Securities Law Coverage of Note Transactions: The Antifraud Provisions*, 35 BUS. LAW. 1567, 1578 (1980).

5. 110 S. Ct. 945, 948-55 (1990).

6. See *Llanos v. United States*, 206 F.2d 852 (9th Cir. 1953), cert. denied, 346 U.S. 923 (1954); *State v. Wiegel*, 165 N.W.2d 695 (N.D. 1969). See generally *Olympic Capital Corp. v. Newman*, 276 F. Supp. 646 (C.D. Cal. 1967); *Prentice v. Hsu*, 280 F. Supp. 384 (S.D.N.Y. 1968).

7. 409 F.2d 989, 992 (1969).

8. While a participation interest and a promissory note are technically different entities they have been treated functionally the same. See *First Citizens Fed. Sav. & Loan v. Worthen Bank*, 919 F.2d 510, 515 (9th Cir. 1990).

was only intended for the protection of unsophisticated investors.<sup>9</sup> The Fifth Circuit rejected this argument. The definition of a security in the 1934 Act included “any note,” declared the court, and the judiciary has interpreted the definition in such a way that all notes are considered to be securities.<sup>10</sup>

Despite the holding in *Lehigh Valley*, other appellate courts began to question the wisdom of treating all promissory notes as securities.<sup>11</sup> These courts reasoned that a literal reading may be inappropriate from a legislative intent and public policy standpoint. Under this view, the antifraud provisions of the federal securities laws were not intended to cover every note without a consideration of how it originated. This view first received judicial recognition in *Lino v. City Investing Co.*<sup>12</sup>

In *Lino*, a 10b-5 action was instituted by a purchaser of a franchise sales center license. The purchaser gave promissory notes and cash to the franchisor in return for the license. The Third Circuit characterized the notes as commercial and not investment in nature because, according to the court, it defied logic to assume that City Investing Company purchased Lino’s note and gave as payment a right to operate a franchise sales center. The court held that the transaction did not involve the “sale” of a security within the definition of sale under the 1933 Act.<sup>13</sup>

In concluding no “sale” had occurred, the court applied the “unless the context otherwise requires” language to the definition of sale.<sup>14</sup> The commercial context surrounding the issuance of the note required a finding of no sale. Each of the definitional sections in the 1933 and 1934 Acts begin with the words, “When used in this subchapter [or chapter], unless the context otherwise requires . . . .”<sup>15</sup> The court assumed, without stating, that the “context clauses” authorize judicial exclusions on the basis of factual circumstances, even if an instrument otherwise falls within the definition of a “security.”

The court never expressly stated that the note involved was not a security. Rather, the narrow holding of the court was that there was no “sale” of a security. However, the court’s references to the definitional sections in the Securities Acts indicate that it squarely confronted the literal reading issue and rejected the policy favoring judicial recognition that every note is a security.<sup>16</sup>

The court warned that a conclusion that every note is a security would allow any consumer who bought an article and issued a note to sue in federal court on the theory that the retailer purchased his security. The

9. *Lehigh Valley*, 409 F.2d at 990.

10. *Id.* at 992.

11. See generally Lipton & Katz, “Notes” Are (Are Not?) Always Securities—A Review, 29 BUS. LAW. 861 (1974).

12. 487 F.2d 689, 694-95 (3d Cir. 1973).

13. See 15 U.S.C. § 77b(3) (1988). (“The term ‘sale’ or ‘sell’ shall include every contract of sale or disposition of a security or interest in a security, for value.”).

14. *Lino*, 487 F.2d at 694.

15. 15 U.S.C. §§ 77b, 78c(a) (1988). These phrases are referred to as the “context clauses.”

16. *Id.* at 695.

paucity of legislative history on this point indicated that Congress did not intend such a result. The court concluded by admonishing that not every plan generating allegations of fraud violates federal securities law.<sup>17</sup>

A. *The "Context" Clause*

The definitional sections in the 1933 and 1934 Acts begin with the words, "When used in this subchapter [or chapter], unless the context otherwise requires—the term 'security' means any note, stock, bond . . . ."<sup>18</sup> In *Lino*, the court implied that the "context clauses" authorize the judiciary to narrow the definition of "security" as the "economic realities" require. As an appellate court has pointed out, however, the "context clauses" provide no such authority.<sup>19</sup>

The most notable feature about the "context clauses" is that they do not appear in the paragraphs defining "security." Instead, these clauses precede all fifteen definitions in the 1933 Act and all forty definitions in the 1934 Act. Plainly, the "context clauses" were not directed particularly at the definitions of "security."<sup>20</sup>

Moreover, the Acts' legislative history does not suggest that the "context" clauses were intended to exempt certain named securities from coverage.<sup>21</sup> Neither the House nor the Senate reports make special references to the clauses or indicate that special kinds of notes are embraced by the Act "only when the context requires." If the drafters had intended that the "context" clause exempt certain named securities from coverage, they made no mention of it.<sup>22</sup>

Rather, early drafts of the proposed legislation show that the "context" clauses refer to the context in which the defined words appear in the statute itself.<sup>23</sup> For example, the word "note" will be given its general definition throughout the statute. However, there may be a particular usage of the word, in a particular section, where the "context" of its usage within the statutory language will require that a different definition be applied.<sup>24</sup>

*Lino* applied the "context" clause directly to the definition of sale.<sup>25</sup> However, other courts have applied an alternative approach. These courts apply the "context" clause directly to the definition of a security.<sup>26</sup> They

17. *Id.*

18. 15 U.S.C. §§ 77b(1), 78c(a)(10) (1988).

19. *See Ruefenacht v. O'Halloran*, 737 F.2d 320, 330-31 (3d Cir. 1984), *aff'd on other grounds*, 471 U.S. 701 (1985).

20. 15 U.S.C. §§ 77b, 78c(a) (1988).

21. *Ruefenacht*, 737 F.2d at 330.

22. *Id.*

23. *Id.* at 331.

24. *Id.*

25. *Lino v. City Investing Co.*, 487 F.2d 689, 694 (3d Cir. 1973).

26. *See, e.g., McClure v. First Nat'l Bank*, 497 F.2d 490 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975); *Joseph v. Norman's Health Club, Inc.*, 336 F. Supp. 307 (E.D. Mo. 1971). However, some state courts have rejected this approach. *See, e.g., State v. Sheets*, 94 N.M. 356, 610 P.2d 760 (Ct. App. 1980), *cert. denied*, 94 N.M. 675, 615 P.2d 992 (1980); *see also* Comment, *Commercial Notes and the Definition of a 'Security' Under the Securities Exchange*

have analyzed the underlying context of a particular transaction to determine its consumer or commercial characteristics. The end result of such analysis would be a conclusion that some promissory notes issued in certain commercial or consumer transactions are not securities; therefore, the Securities Acts would have no application.

The view espoused in *Lino*, that not all promissory notes should be treated as securities, began to receive wide federal judicial recognition in the early 1970s. A wide divergence of opinion developed as to what test should be applied for determining when promissory notes are securities. The four separate tests were developed by the courts of appeals. Each will be discussed below briefly.

### B. Investment Versus Commercial Test

The first of these tests is the investment versus commercial transaction test.<sup>27</sup> Prior to *Reves*, most courts of appeals used the investment versus commercial test.<sup>28</sup> Under this test a note issued in connection with an investment type transaction is a security. A note issued in a commercial-type transaction is not a security. The focus is on the nature of the transaction giving rise to the issuance of the note.<sup>29</sup>

In *Zabriskie v. Lewis*,<sup>30</sup> the Tenth Circuit formulated an eight factor test to determine whether certain promissory notes possessed the characteristics of "investment" or "commercial" notes. "Investment" notes were considered securities.<sup>31</sup>

The factors identified by the Tenth Circuit are: (1) whether the issuer used the proceeds to buy specific assets or services, rather than for general financing; (2) the amount of risk, if any, to the initial investment; (3) whether the payee is given certain rights; (4) whether repayment is contingent on profits or production; (5) whether there are a large number of notes or payees; (6) whether the dollar amount involved is large; (7) whether the instruments are fixed-time notes rather than demand notes; and (8) the parties' characterization of the note and the transaction.<sup>32</sup>

---

*Act of 1934: A Note is a Note is a Note?*, 52 NEB. L. REV. 478 (1973); Comment, *Notes as Securities Under the Securities Act of 1933 and the Securities Exchange Act of 1934*, 36 MD. L. REV. 233 (1976). But see Hammett, *Any Promissory Note: The Obscene Security—A Search for the Non-Commercial Investment*, 7 TEX. TECH L. REV. 25, 38-40 (1975).

27. While most of the lower federal courts describe this approach as the commercial-investment dichotomy test, the Supreme Court, in *Reves*, refers to it as the investment versus commercial test. For purposes of this note, investment versus commercial test will be used.

28. See, e.g., *Futura Dev. Corp. v. Centex Corp.*, 761 F.2d 33, 40-41 (1st Cir. 1985), cert. denied, 474 U.S. 850 (1985); *C.N.S. Enters. v. G. & G. Enters.*, 508 F.2d 1354, 1359 (7th Cir.), cert. denied, 423 U.S. 825 (1975); *Zabriskie v. Lewis*, 507 F.2d 546, 550-52 (10th Cir. 1974); *Bellah v. First Nat'l Bank*, 495 F.2d 1109, 1111-14 (5th Cir. 1974); *Lino v. City Investing Co.*, 487 F.2d 689, 693-96 (3d Cir. 1973).

29. See Lipton & Katz, "Notes" Are Not Always Securities, 30 BUS. LAW. 763 (1975).

30. 507 F.2d 546, 551 (10th Cir. 1974).

31. *Id.* at 551.

32. *Id.*

This test has also been adopted in Oklahoma under the Oklahoma Securities Act.<sup>33</sup> In *State v. Hoephner*,<sup>34</sup> the Court of Criminal Appeals adopted the eight-part Tenth Circuit test. In *Hoephner*, an unsophisticated investor was approached with the prospect of investing her money and receiving a high rate of return. She was given a promissory note, and she did not receive any goods or services for her money. Applying the *Zabriskie* test, the court ruled that under these facts the note in question was an "investment" note and, therefore, a security.<sup>35</sup>

Other state courts have rejected the investment versus commercial analysis. *State v. Sheets*<sup>36</sup> is an example of those courts which have rejected this approach. In *Sheets*, the defendant was convicted of selling unregistered securities. Those who gave money to the defendant received a promissory note in return and were promised a stratospheric rate of interest over the life of the note.<sup>37</sup>

Relying on *Zabriskie*, the defendant argued that notes are not "securities" unless they can be characterized as investment notes under the investment versus commercial test. The court rejected the defendant's argument and chose not to adopt the investment versus commercial test. Instead, the court ruled that any instrument coming within the statutory definition of a security is a security. Since the phrase "any note" appears in the definition of a security, the usual, ordinary meaning of "note" should apply. The documents issued by the defendant were notes and therefore, the court held, they were "securities."<sup>38</sup>

### C. The Howey Test

The second test is the test for "investment contracts" created in *SEC v. W.J. Howey*.<sup>39</sup> The definition of a "security" includes "investment contracts."<sup>40</sup> Both the Eighth Circuit and the District of Columbia Circuit have applied the test for "investment contracts" to promissory notes.<sup>41</sup> The *Howey* test defines an "investment contract" through the use of four factors. First, there must be an investment of money. Second, the investment must be in a common enterprise. Third, the investment must create a reasonable expectation of profit. Fourth, the profit expected must be derived solely from the efforts of others.<sup>42</sup>

33. 71 OKLA. STAT. § 1-827 (1981 & Supp. 1990).

34. 574 P.2d 1079 (Okla. Crim. App. 1978).

35. *Id.* at 1083.

36. 94 N.M. 356, 610 P.2d 760, 765 (1980), *cert. denied*, 94 N.M. 675, 615 P.2d 992 (1980).

37. *Id.*, 610 P.2d at 763.

38. *Id.*, 610 P.2d at 765.

39. 328 U.S. 293 (1946).

40. See *supra* note 1 and accompanying text.

41. See *Baurer v. Planning Group, Inc.*, 669 F.2d 770 (D.C. Cir. 1981); *Arthur Young & Co. v. Reeves*, 856 F.2d 52, 53-55 (8th Cir. 1988), *rev'd on other grounds*, 494 U.S. 56 (1990).

42. *Howey*, 328 U.S. at 301. The Supreme Court appears to have relaxed the "solely" requirement. See *United Hous. Found. v. Forman*, 421 U.S. 837, 852 (1975) ("reasonable expectations of profits to be derived from the entrepreneurial or management efforts of others").

In *Arthur Young & Co. v. Reves*,<sup>43</sup> the Eighth Circuit applied the *Howey* test to demand promissory notes issued by a farmer's cooperative (co-op). The court did not give a reason for choosing the *Howey* test over the other available tests.<sup>44</sup> Nevertheless, the court concluded that the demand notes were not securities because they failed the *Howey* test.<sup>45</sup>

First, the co-op issued the notes in exchange for short-term loans with fixed interest rates. The court ruled the transaction was more akin to a commercial lending arrangement than an investment transaction. Thus, the transaction failed the first element of the *Howey* test, which requires an "investment" of money.<sup>46</sup>

Moreover, the third element of the *Howey* test, reasonable expectation of profit, was not satisfied. The court ruled that profit does not mean any return beyond principal. Rather, profit under the *Howey* test means profit of the type typically associated with an investment. This includes "capital appreciation resulting from the development of the initial investment or a participation in earnings resulting from the use of investors' funds."<sup>47</sup> The demand noteholders did not participate in the co-op's earnings by virtue of their ownership of the demand notes. There was also no prospect of capital appreciation. Therefore, the court ruled, the demand noteholders did not expect a profit as that term is used in *Howey*.<sup>48</sup>

#### D. Risk Capital Test

The third test is the "risk capital" test. The Ninth Circuit and the Sixth Circuit have adopted the "risk capital" test which analogizes a note to an "investment contract."<sup>49</sup> Under this test, the ultimate question is whether the funding party contributed risk capital subject to the managerial efforts of others.<sup>50</sup> The underlying transaction must be examined to determine whether it more closely resembles a "loan," making it a non-security, or whether it has risk factors more closely associated with "risk capital," making it more appropriately a security.<sup>51</sup>

In applying the risk capital test, the Ninth Circuit looked at six factors, none dispositive, to determine whether the funding party invested "risk capital." These factors are: (1) the length of time between the note's issuance

43. 856 F.2d 52, 53-55 (8th. Cir. 1988), *rev'd on other grounds*, 494 U.S. 56 (1990).

44. *Id.* at 54. The court incorrectly stated the "*Howey* test defines a security . . ." *Id.* *Howey* sets forth a test for defining "investment contracts," one of the items listed in the definition of a security. The *Howey* test was never intended to be an all-encompassing definition of a security.

45. *Id.*

46. *Id.*

47. *Id.*

48. *Id.* at 55. The Supreme Court, in *Reves*, ruled that profit in the context of notes includes interest. *Reves v. Ernst & Young*, 110 S. Ct. 945, 950-52 (1990).

49. *See, e.g., Underhill v. Royal*, 769 F.2d 1426, 1431 (9th Cir. 1985); *American Bank & Trust v. Wallace*, 702 F.2d 93, 96 (6th Cir. 1983).

50. *Underhill*, 769 F.2d at 1431 (citing *United California Bank v. THC Financial Corp.*, 557 F.2d 1351, 1356-58 (9th Cir. 1977)).

51. *Great W. Bank & Trust Co. v. Kotz*, 532 F.2d 1252, 1255 (9th Cir. 1976).



and the due date; (2) whether there is collateral for the note; (3) the form of the obligation; (4) the circumstances of the issuance; (5) the relationship between the amount borrowed and the size of the borrower's business; and (6) the contemplated use of the proceeds.<sup>52</sup>

The Ninth Circuit applied these factors in *Great Western Bank & Trust Co. v. Kotz*, where a bank brought an action under the Securities Acts to recover losses incurred on an unsecured note given in connection with a loan agreement. The note was not renewable without the consent of the lender and the loan agreement allowed the lender to declare default at the faintest sign of insecurity. Based on these facts, the court ruled the note was not a security.<sup>53</sup>

#### E. The Family Resemblance Test

The fourth test is the "family resemblance" test developed by the Second Circuit. After surveying the prior cases decided by other lower federal courts, the Second Circuit in *Exchange National Bank v. Touche Ross*<sup>54</sup> decided the best alternative lay in greater recourse to the statutory language. Looking to the plain language in the definitional sections, the Second Circuit began with the presumption that any note with a term of more than nine months is a "security."<sup>55</sup> Then, relying on the "context" clause, the court concluded this presumption is rebuttable if the "context" of the transaction indicates that a certain note is obviously not a security.<sup>56</sup> The court, applying a "family resemblance" test, then identified a list of instruments commonly considered notes that should not be considered securities.<sup>57</sup> Under this portion of the test, the following "notes" are not to be considered securities:

the note delivered in consumer financing, the note secured by a mortgage on a home, the short-term note secured by a lien on a small business or some of its assets, the note evidencing a "character" loan to a bank customer, short-term notes secured by an assignment of accounts receivable, or a note which simply formalizes an open-account debt incurred in the ordinary course of business (particularly if, as in the case of the customer of a broker, it is collateralized).<sup>58</sup>

An exception for "loans by commercial banks for current operations" was subsequently added in *Chemical Bank v. Arthur Andersen & Co.*<sup>59</sup>

52. *Id.* at 1258.

53. *Id.* at 1259-60.

54. 544 F.2d 1126, 1131-35, 1138 (2d Cir. 1976), *modified*, *Chemical Bank v. Arthur Andersen & Co.*, 726 F.2d 930 (2d Cir. 1984).

55. *Id.* at 1137.

56. *Id.* at 1138. The court derives authority for examining the underlying "context" of a transaction from the "unless the context otherwise requires" introductory clause preceding the definitional sections in the Acts. *See supra* notes 18-24 for further discussion of this clause.

57. *Exchange Nat'l Bank v. Touche Ross*, 544 F.2d 1126, 1138 (2d Cir. 1976).

58. *Id.*

59. 726 F.2d 930, 939 (2d Cir. 1984), *cert. denied*, 469 U.S. 884 (1984).

The “family resemblance” test, therefore, permits an issuer to rebut the presumption that a note is a security if the issuer can demonstrate that the note in question closely resembles an item on the above judicially created list of exceptions.<sup>60</sup> If a note does not bear a strong resemblance to one of the instruments identified in the list, and it has a maturity exceeding nine months, the Securities Acts under the “family resemblance” test should generally be held applicable.<sup>61</sup>

### III. *Reves v. Ernst & Young*

The issue of whether promissory notes should be treated as securities and, if so, under what test finally reached the Supreme Court in *Reves v. Ernst & Young*.<sup>62</sup> *Reves* focused on the nontraditional financing method employed by a farmer’s cooperative (co-op) located in Arkansas and Oklahoma to raise money for its general business operations.<sup>63</sup> The scheme involved the offer of uncollateralized and uninsured promissory notes. The notes were payable on demand at a variable rate of interest adjusted monthly so that the rate paid was always higher than the rate paid by other local financial institutions. The note program was marketed as an “investment program,” and was offered to both members and non-members. The note sales were continuous for a number of years and were ongoing. However, no information regarding the co-op’s financial status had ever been disclosed to noteholders at the time of their purchases. The only financial information available was a statement of the co-op’s total assets, which appeared periodically in the co-op newsletter.

The co-op employed Arthur Young to audit and report the co-op’s 1981 and 1982 financial statements.<sup>64</sup> However, these audited financial statements were never distributed to the co-op’s members or the demand noteholders. Except for the advertisements and placements in the co-op newsletter, the only financial information about the co-op was disseminated at the co-op’s annual meetings.

In 1984, the co-op filed bankruptcy, leaving over 1,600 people holding notes worth a total of \$10 million. The noteholders filed a class action lawsuit under Rule 10b-5 against Arthur Young. The suit alleged the accounting firm had committed securities fraud by overvaluing one of the co-op’s major assets. Although the plaintiffs prevailed in district court,<sup>65</sup> the

60. *Chemical Bank*, 554 F.2d at 1138.

61. *Id.*

62. 110 S. Ct. 945 (1990).

63. *Id.* at 947-48. At the time of the filing of the lawsuit the co-op, an agricultural cooperative, had approximately 23,000 members. It charged only a nominal membership fee to the farmer-members it served. For the most part, the co-op, prior to retaining the services of Arthur Young in 1981, operated a “traditional” farmer’s cooperative in northwest Arkansas and northeast Oklahoma (i.e. it obtained the bulk of its operating funds from traditional borrowing sources such as banks). *Arthur Young & Co. v. Reves*, 856 F.2d 52, 53 (8th Cir. 1988).

64. *Id.* at 948. Arthur Young was the predecessor to respondent Ernst & Young.

65. *Robertson v. White*, 635 F. Supp. 851 (W.D. Ark. 1986).

Eighth Circuit reversed. As noted above, it did so on the basis that the notes were not securities under the *Howey* test.<sup>66</sup> The plaintiffs appealed to the Supreme Court, which granted certiorari.

#### A. *Treatment By The Supreme Court*

The Supreme Court began its analysis of the *Reves* notes by recognizing that Congress' purpose in enacting the securities laws was to regulate investments.<sup>67</sup> To achieve its goal of protecting investors, Congress defined the term "security" broadly enough to include virtually any instrument that might be sold as an investment.<sup>68</sup>

Nonetheless, the Court emphasized that the securities laws are not intended to provide a general federal cause of action for fraud.<sup>69</sup> The Court also reiterated that in analyzing a particular transaction, the courts must look to the economics of the transaction under investigation.<sup>70</sup> Thus, a proper analysis would go beyond the name given a particular transaction and examine its underlying substance.<sup>71</sup> In adopting this approach, the Court simply recognized the analysis which the lower courts had been applying for years — the Securities Acts' enumerative definitions should not be read literally.<sup>72</sup>

Turning to such analysis, the Court first considered and then rejected applying the *Landreth Timber v. Landreth* formula to notes.<sup>73</sup> The Court also expressly rejected the reasoning of those circuits that had applied the *Howey* test for "investment contracts."<sup>74</sup> It reasoned that though demand notes may not be "investment contracts," this conclusion did not mean that such notes could not be notes within the statutory definition of a security.<sup>75</sup> The Court concluded that the various parts of the statutory definitions would be superfluous if a promissory note could only be considered a security when it satisfies a test for an entirely different variety of instrument, such as "investment contracts."<sup>76</sup> Furthermore, it concluded that the appli-

66. *Arthur Young & Co. v. Reves*, 856 F.2d 52, 53-55 (8th Cir. 1988). See *supra* notes 43-48 and accompanying text.

67. *Reves*, 110 S. Ct. at 949.

68. *Id.* (citing *United Housing Found. v. Forman*, 421 U.S. 837, 847-48 (1975)).

69. *Id.* (citing *Marine Bank v. Weaver*, 455 U.S. 551, 556 (1982)).

70. *Id.* (citing *Tcherepnin v. Knight*, 389 U.S. 332, 336 (1967)).

71. *Id.*

72. *Id.* at 950.

73. *Id.* (citing *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 692 (1985)). The Court indicated in *Landreth Timber* that an instrument bearing the name stock will normally be considered a security provided it is negotiable, offers the possibility of capital appreciation, and carries the right to dividends. In *Landreth Timber*, the Court held that stock is always a security if it has the economic characteristics traditionally associated with stock. *Landreth Timber*, 471 U.S. at 687. Although the Court refused to rule out a similar *per se* rule for notes, it intimated that such a rule would be unjustified. *Reves*, 110 S. Ct. at 949.

74. *Id.* at 951; see *supra* notes 39-48 and accompanying text. The Court considered the Ninth Circuit's "risk capital" test (described *supra* notes 49-53 and accompanying text) to be virtually identical to the *Howey* test. *Id.*

75. *Id.*

76. *Id.* (citing *Landreth Timber*, 471 U.S. at 692).

cation of the *Howey* test to notes would be inconsistent with Congress' intent to regulate the entire body of instruments sold as investments.<sup>77</sup>

The Court also rejected the Eighth Circuit's argument that the demand characteristic of the notes is uncharacteristic of a security.<sup>78</sup> The Eighth Circuit based its conclusion on the idea that instant liquidity is inconsistent with the risks ordinarily associated with a security.<sup>79</sup> In rejecting this argument, the Court noted that common stock, the paradigm of a security, is even more readily liquid than demand notes.<sup>80</sup> The Court pointed out that the demand feature only eliminates risk when and if payment is made, whereas the sale of a share of stock through a national exchange and the receipt of the proceeds usually occur simultaneously.<sup>81</sup>

However, the Court did not expressly reject the investment versus commercial test.<sup>82</sup> Instead, the Court viewed the investment versus commercial and the family resemblance tests as two ways of stating the same general approach.<sup>83</sup>

#### *B. Supreme Court's Formulation of The "Family Resemblance" Test*

After reviewing the four separate tests developed by the courts of appeals, the Court selected the "family resemblance" test which, it felt, provided the best framework for analysis.<sup>84</sup> First, with very little discussion, analysis or citation of authority, the Court accepted the Second Circuit's approach of eliminating from coverage under the Securities Acts the above identified seven categories of promissory notes. Realizing the difficulty an issuer or maker of a note faces in trying to prove that a certain instrument resembles one of the excepted items identified by the Second Circuit, the Court then formulated four general factors for use in determining whether a note resembles one of the enumerated categories of non-securities.<sup>85</sup>

The first factor examines the motivations prompting a reasonable seller and buyer to enter into the transaction. The second factor examines the plan of distribution of the instrument. The third factor considers the reasonable expectations of the investing public as to the application of the Securities Acts to the transaction. The fourth factor addresses the existence of another regulatory scheme which significantly reduces the risk of the instrument, thereby rendering the protection of the federal securities laws unnecessary.<sup>86</sup>

77. *Id.*

78. *Id.* at 953.

79. *Arthur Young & Co. v. Reves*, 856 F.2d 52, 54 (8th Cir. 1988).

80. *Reves*, 110 S. Ct. at 953.

81. *Id.*

82. *Id.* at 951.

83. *Id.*

84. *Id.* See *supra* notes 54-61 and accompanying text for further discussion of the "family resemblance" test.

85. *Id.* The Court criticized the Second Circuit for not providing enough guidance as to "what it is about those instruments that makes them 'non-securities.'" *Id.*

86. *Id.* Under the first factor, "if the seller's purpose is to raise money for the general

Thus, the first step under the *Reves* test is to apply these four factors to determine whether the note bears a strong family resemblance to a category of non-securities on the judicially created list of exceptions. If the note does not resemble an existing category of non-securities, the courts then, in step two of the *Reves* test, apply the same four factors to determine whether a new category should be added to the list.<sup>87</sup>

Applying this analytical framework to the facts in *Reves*, the Court concluded that the co-op's motive in selling the notes was to raise money for general business operations.<sup>88</sup> On the other hand, it stated that the purchaser's motive in buying them was to earn a profit in the form of interest at a rate constantly revised to keep it above the rate paid by local banks.<sup>89</sup> Accordingly, both sides considered the scheme as an investment in a business enterprise rather than a commercial or consumer transaction.<sup>90</sup>

The Court then examined the co-op's plan of distribution. It pointed out that the notes were offered and sold to a broad segment of the public. This, the Court felt, was all that was necessary to establish that there was "common trading" in the instruments.<sup>91</sup> As to the third point, the Court felt that the public's reasonable expectations also lead to a conclusion that the notes were securities. The notes were advertised as investments and no other reasons existed to lead a reasonable person to conclude otherwise.<sup>92</sup>

---

use of a business enterprise or to finance substantial investments and the buyer is interested primarily in the profit the note is expected to generate, the instrument is likely to be a 'security.'" *Id.* at 952. "If the note is exchanged to facilitate the purchase and sale of a minor asset or consumer good, to correct for the seller's cash-flow difficulties, or to advance some other commercial or consumer purpose, on the other hand, the note is less sensibly described as a 'security.'" *Id.* The Court cited *Forman* to illustrate a situation where the most common form of security, stock, was purchased not for profit, but for an asset. *Id.* (citing *United Hous. Found. v. Forman*, 421 U.S. 837, 851 (1975)). The Court held the stock not to be a security because the purchasers bought the shares to acquire low cost apartments in a housing cooperative. *Id.* at 952-53.

Under the second factor, the plan of distribution of the instrument, one should examine the instrument to determine whether it is one in which there is "common trading for speculation or investment." *Id.* at 952. All that is necessary to establish the requisite "common trading" is an offering to a broad segment of the public. *Id.*

Under the third factor, the Court will consider instruments to be securities on the basis of the public's expectations, even where an economic analysis of the circumstances of the particular transaction might suggest that the instruments are not securities as used in the transaction. *Id.* The fourth factor came to light in *Marine Bank v. Weaver*, where certificates of deposit were held not to be securities because they were insured by the Federal Deposit Insurance Corporation and subject to substantial regulation under the federal banking laws. *Id.* (citing *Marine Bank v. Weaver*, 455 U.S. 551, 557-59 (1982)). The risk reducing factor created by alternative regulation was first recognized by the Court in *Teamsters v. Daniel*, where a pension plan was held not to be a security because, among other reasons, it was comprehensively regulated under the Employee Retirement Income Security Act of 1974. *Id.* at 953 (citing *Teamsters v. Daniel*, 439 U.S. 551, 569-70 (1979)).

87. *Id.*

88. *Id.* at 952.

89. *Id.* at 953.

90. *Id.*

91. *Id.*

92. *Id.*

Lastly, the Court found no other state or federal regulatory scheme to reduce the risk associated with the uncollateralized and uninsured notes.<sup>93</sup> The foregoing analysis convinced the Court that the demand notes fell within the term “note” in section 3(a)10 of the 1934 Act.<sup>94</sup>

#### IV. Case Law Applying *Reves*: Trends & Problems

##### A. Has *Reves* Changed Anything?

Since the *Reves* decision a number of federal courts have been called upon to apply the analysis it developed. A look at these new cases indicates that little has changed as a result of *Reves* except the labels used.

The proposition that *Reves* has had little substantive impact is best illustrated by the Tenth Circuit’s analysis in *Holloway v. Peat, Marwick, Mitchell & Co. (Holloway II)*.<sup>95</sup> The original *Holloway* opinion (*Holloway I*) was decided prior to *Reves*.<sup>96</sup> While *Holloway I* was on appeal, the Supreme Court issued the *Reves* decision. The Court then vacated *Holloway I* and remanded it to the Tenth Circuit for reconsideration in light of *Reves*.<sup>97</sup>

After the Supreme Court remanded *Holloway I*, the Tenth Circuit issued *Holloway II*, which reaffirmed in all respects its original decision.<sup>98</sup> The court recognized that it had essentially performed the *Reves* analysis in *Holloway I*.<sup>99</sup> This was evidenced by the fact that the *Reves* test analyzed the same facts as the *Zabriskie* eight factor investment versus commercial test applied in *Holloway I*. *Reves* factor one, the motivations of the buyer and seller in exchanging the instrument, is closely related to *Zabriskie* factors one and four.<sup>100</sup> *Reves* factor two, the instrument’s plan of distribution, is analyzed under *Zabriskie* factors five and six.<sup>101</sup> *Reves* factor three, the reasonable expectations of the investing public, is analyzed under *Zabriskie* factor eight.<sup>102</sup>

93. *Id.*

94. *Id.*

95. 900 F.2d 1485 (10th Cir. 1990).

96. *Holloway v. Peat, Marwick, Mitchell & Co.*, 879 F.2d 772, 774-78 (10th Cir. 1989) (*Holloway I*).

97. *Peat Marwik Main & Co. v. Holloway*, 110 S. Ct. 1314 (1990).

98. *Holloway II*, 900 F.2d at 1487-88.

99. *Id.* at 1487. In *Holloway I*, the Tenth Circuit applied the eight factor investment versus commercial test set forth in *Zabriskie v. Lewis*, 507 F.2d 546, 551 n.9 (10th Cir. 1974). Applying the eight-factor test, the court ruled that the thrift certificates and passbook savings certificates were investment, not commercial, instruments. *Holloway II*, 900 F.2d at 1488-89. Investment instruments are considered securities. *Id.*

100. *Holloway II*, 900 F.2d at 1488. *Zabriskie* factor one asks whether the proceeds were used to buy specific assets or services rather than general financing. *Zabriskie*, 507 F.2d 551 n.9. *Zabriskie* factor four looks at whether repayment is contingent on profit or production. *Id.*

101. *Id.* The fifth and sixth *Zabriskie* factors are the large number of notes or payees and the large dollar amount, respectively. *Id.*

102. *Id.* *Zabriskie* factor eight examines the characterization given the transaction by the parties themselves.

The major analytical difference between *Reves* and *Holloway* lies in the treatment of other federal regulatory schemes.<sup>103</sup> The issuers in *Holloway I* were subject to regulation under the Bank Holding Company Act (BHCA), a federal statute.<sup>104</sup> However, the Tenth Circuit concluded the BHCA did not satisfy the disclosure and remedial purposes of the Securities Acts. The BHCA's purpose was to protect bank depositors, not investors in the holding company's nonbank subsidiaries.<sup>105</sup> Nevertheless, in *Holloway I* the court stated that even if an instrument qualified as a security under the investment versus commercial test, other federal regulation might still remove the instrument from the protection of the federal securities laws.<sup>106</sup>

In *Holloway II*, the Tenth Circuit recognized that *Reves* alters the original *Holloway I* analysis.<sup>107</sup> The existence of some other regulatory scheme that significantly reduces the risk of the instrument is now one of four factors used to determine whether the instrument is or should be categorized as a non-security. The Tenth Circuit recognized that this change in emphasis did not affect the outcome of the case.<sup>108</sup>

The only other appellate case applying *Reves* arose in the Ninth Circuit. In *First Citizens Savings & Loan Association v. Worthen Bank*,<sup>109</sup> a savings and loan association that entered into a loan participation agreement sued the principal lender, a commercial bank, seeking rescission. The note underlying the loan participation agreement evidenced a loan by the bank to a developer to finance a development project. Under Arizona law, if the note underlying the loan participation is a security, then the loan participation agreement is a security.

The Ninth Circuit formerly applied the "risk capital" test in determining whether a note was a security.<sup>110</sup> The court noted, however, that *Reves* rejected this test in favor of the Second Circuit's "family resemblance" test. Under this test, the court found that "a note evidencing a loan made by a commercial bank to finance current operations of a borrower" was part of the judicial list of exceptions to the general rule that all notes are securities. In *First Citizens*, the note underlying the agreement evidenced a loan by a commercial bank to a developer to finance one of his development projects. As such, the court ruled that it fit squarely into the exception and did not constitute a "security" under federal law.<sup>111</sup>

103. *Id.* The importance of alternative federal regulatory schemes was articulated by the Supreme Court in *Marine Bank v. Weaver*, 455 U.S. 551 (1982). In *Marine Bank*, the Court ruled that if instruments that might otherwise qualify as securities were covered by another federal regulatory scheme, the protection provided by the federal securities laws would be unnecessary. *Marine Bank*, 455 U.S. at 558-59.

104. 12 U.S.C. §§ 1841-1850 (1988).

Both the trust company and finance company were subsidiaries of a bank holding company.

105. *Reves*, 879 F.2d at 786.

106. *Id.*

107. *Holloway v. Peat, Marwick, Mitchell & Co.*, 900 F.2d 1485, 1488 (10th Cir. 1990) (*Holloway II*).

108. *Id.*

109. 919 F.2d 510, 515 (9th Cir. 1990).

110. *Id.*

111. Strict adherence to *Reves* would require the Ninth Circuit to apply the four factors,

Though the Supreme Court in *Reves* expressly rejected the “risk capital” approach, the result in *First Citizens* would have been the same. The note underlying the loan participation was given in exchange for a commercial loan. The transaction was purely private, and the terms were negotiated between a commercial lender and borrower. None of the risk factors associated with “risk capital” were present.<sup>112</sup> Like *Holloway*, *First Citizens* indicates that *Reves* has only changed the terms used, not the result.

### B. The Exception For Mortgage Backed Notes

It is not clear from *Reves* whether the exception for “note[s] secured by a mortgage on a home” only applies to the traditional loan arrangement between borrower and lender.<sup>113</sup> *Reves* did not define the scope of this definition. As a result, an argument was made in *Mercer v. Jaffe, Snider, Raitt & Heuer, P.C.*, that mortgage backed home equity promissory notes marketed by a broker-dealer to the general public fall squarely within the “note secured by a mortgage on a home” exception.<sup>114</sup> The defendants

---

which it did not do, to determine whether the note at issue resembles one of the categories. However, the court obviously saw no reason to apply the four factors because the note underlying the participation agreement was the same type of note referred to in the category.

112. See *supra* note 50 and accompanying text.

113. *Reves v. Ernst & Young*, 110 S. Ct. 945, 951 (1990).

114. 736 F. Supp. 764, 769-70 (W.D. Mich. 1990), *aff'd*, 931 F.2d 893 (6th Cir.) (unpublished opinion), *aff'd*, 933 F.2d 1008 (6th Cir. 1991) (unpublished opinion). The “note secured by a mortgage on a home category” was at issue in *Singer v. Livoti*, 741 F. Supp. 1041, 1049-50 (S.D.N.Y. 1990). In *Singer*, the plaintiffs loaned money, on advice of their defendant-attorney, to a developer who gave them a promissory note. To secure payment, the developer executed and delivered a mortgage on eighteen building lots. The mortgage was never recorded, and the developer failed to repay the note.

The court concluded that the promissory note was not a security because it resembled the “note secured by a mortgage on a home” category of notes which are not securities. *Id.* at 1049. The court recognized the note at issue in *Singer* was not secured by a mortgage on a home but by a mortgage on a number of homes. *Id.* However, the court did not see this as a problem. The note was issued in a commercial lending context through the conduit of a lawyer. Today, a substantial number of conventional mortgage loans are made by private individuals with the aid of knowledgeable intermediaries such as lawyers and real estate brokers. *Id.* It is hard to see, the court wondered, why an exception for a conventional real estate mortgage should be different simply because it covered “a home” rather than an office building, a series of homes or vacant land. *Id.*

*Diaz Vicente v. Obenauer*, 736 F. Supp. 679 (E.D. Va. 1990), is the only other federal district case, as of this writing, applying *Reves*. The plaintiffs in *Obenauer* invested money in a real estate project pursuant to participation agreements. A subsequent letter from the defendants confirmed modifications to the participation agreements. The defendants used the money for personal expenses and never repaid the principal or interest.

The court viewed the letter as a promissory note and, accordingly, applied the *Reves* analysis. *Id.* at 693. It concluded that the letter in no way resembled any of the nonsecurity notes enumerated in *Reves*. *Id.*

One state court of appeals and two state supreme courts have held that *Reves* applies to state securities laws. This is not surprising considering the definition of a security in most state securities acts is virtually identical to the federal definition.

In *Caucus Distribs. v. Department of Commerce*, 793 P.2d 1048 (Alaska 1990), and *Caucus v. Maryland Sec. Comm'r*, 320 Md. 313, 577 A.2d 783 (1990), securities commissioners from



pointed to this language in arguing the mortgage backed notes were per se not securities.

The court correctly rejected this mechanical interpretation of the "note secured by a mortgage on a home" category.<sup>115</sup> This language was meant to apply only to mortgage backed notes given in the context of a traditional face-to-face loan transaction between a borrower and a commercial or consumer lender. The non-security status of "the note secured by a mortgage on a home" was not intended to apply to transactions between an individual investor and a broker-dealer selling the mortgage backed notes on a mass market basis.<sup>116</sup> This conclusion is consistent with the Supreme Court's directives in *Reves*.

In *Reves*, the Court exempted certain notes issued in a consumer or commercial context from coverage under the Securities Acts. A look at the seven categories of notes that are not securities shows that they all have commercial characteristics.<sup>117</sup> The mortgage backed notes at issue in *Mercer* had all the characteristics of an investment. Thus, even though they fell within the literal language of the exception, they were clearly not the type of routine commercial arrangements excluded from coverage under *Reves*.

### C. Weighing The Four Factors

A recent federal district court case illustrates one of the problems with the *Reves* opinion. In *Reves*, the Supreme Court did not set forth the relative weights of the four factors. It is unclear from *Reves* what the result would be where some of the factors lead to a conclusion that the instrument at issue should be considered a security while the other factors point in the opposite direction. This dilemma is vividly illustrated in *Fulton Bank v. McKittrick & Briggs Securities*.<sup>118</sup>

The defendants in *Fulton Bank* agreed to construct and lease a laundry facility to a municipality. The defendants were short of funds, and consequently they enlisted the help of a broker-dealer who sold a "Certificate of Participation" in the right to receive lease payments to the bank.<sup>119</sup> Payments

---

Alaska and Maryland issued cease and desist orders directing that Caucus Distributors, a Lyndon LaRouche organization, stop issuing uninsured and uncollateralized promissory notes in exchange for contributions to its political fundraising activities. The highest courts of both Maryland and Alaska ruled the notes were securities under *Reves*. *Caucus Distribs.*, 793 P.2d at 1056; *Maryland Securities*, 577 A.2d at 791.

In *State v. Saas*, 58 Wash. App. 305, 792 P.2d 554 (1990), the Washington court of appeals reversed a plea of guilty to securities fraud. The basis for the court's decision was that the notes given by the defendants were not securities under *Reves*. *Id.*, 792 P.2d at 555-58.

115. *Mercer*, 736 F. Supp. at 769.

116. *Id.*

117. See *supra* note 58-59 and accompanying text.

118. Nos. 88-0144, 88-0882, 1990 U.S. Dist. LEXIS 11371 (E.D. Pa. Aug. 27, 1990) (unpublished opinion).

119. The bank was led to believe the lease payments were tax exempt. In fact, the interest component of the lease payments was not tax exempt.

to the bank eventually ceased, leaving over one million dollars outstanding.<sup>120</sup>

Applying the *Reves* four-factor test, the court concluded the participation interest did not resemble any of the six categories of notes which are not securities.<sup>121</sup> Therefore, the participation interest was a security. However, an analysis of the underlying facts sheds some doubt on the court's conclusion.

The *Fulton Bank* opinion clearly indicates that the defendants' motive in selling participation interests in the right to receive lease payments was to correct short-term cash flow difficulties. The Supreme Court made clear in *Reves* that, under factor one, if the seller's purpose in soliciting funds is to correct short-term cash flow problems, the instrument is likely not to be a security. Yet the court overlooked this aspect of the test.

A look at *Reves* factor two, the plan of distribution, indicates there was no such plan. The participation interest was sold from one broker-dealer to another broker-dealer, and ultimately resold to the bank. The requisite "common trading" in the instrument was not met.

However, *Reves* factor three, the reasonable expectations of the investing public, indicates the certificate was a security. The financial community regards this type of instrument as an investment security. The Securities and Exchange Commission takes the position that participation interests in tax exempt lease purchase agreements are "municipal securities" subject to the rules of the Municipal Securities Rule-Making Board.<sup>122</sup> *Reves* factor four also indicated the certificate was a security. There was no alternative regulatory scheme which reduced the risk of the investment.

Thus, *Reves* factors one and two indicated the participation interest was not a security, while *Reves* factors three and four indicated otherwise. The problem is that *Reves* does not set forth the relative weight to be given each of the four factors. It is unclear whether one factor can lead to adding an instrument to the list of non-securities if the other factors point in the opposite direction. The practicing lawyer and judge are left with very little guidance when confronted with a close case. Nevertheless, the court in *Fulton Bank* ruled the perceptions of the financial community supported the argument that the participation interest was a security. Without so stating, the court relied exclusively on *Reves* factor three in reaching the conclusion it did.

## V. Conclusion

In *Reves*, the Supreme Court attempted to resolve a dispute among the courts of appeals as to what test should be applied for determining when

120. The municipality was unaware of the assignment of payments under the LPSA to the bank. Eventually, the municipality exercised its option to purchase the laundry facility. *Fulton Bank*, 1990 U.S. Dist. LEXIS 11371, at \*6.

121. Before applying the *Reves* analysis the court determined the "Certification of Participation" was similar to a note. The certificate entitled the bank to regular monthly payments consisting of principal and interest. As such, the certificate closely resembled a note. *Id.*, 1990 U.S. Dist. LEXIS 11371, at \*12-13.

122. 2 Municipal Sec. Rule-Making Board Rep. 13 (Jan. 1982).

notes are securities. Though the Court adopted the Second Circuit's family resemblance test, the case law applying *Reves* indicates not much has changed except the labels used. The Tenth Circuit in *Holloway* reached the same result under the investment versus commercial test as it did under the *Reves* version of the family resemblance test. Since prior to *Reves*, most courts of appeals used the investment versus commercial test, *Holloway* would indicate *Reves* will have little impact in those circuits. Moreover, *First Citizens* indicates *Reves* should not change the outcome in the Ninth Circuit and the Sixth Circuit, which formerly applied the "risk capital" test. While these cases reveal *Reves* will have minimal substantive impact, other cases bring to light problems with the *Reves* analysis.

One of the problems the practitioner confronts in applying *Reves* is illustrated in *Fulton Bank*. In *Fulton Bank* two of the *Reves* factors indicated the participation interest was a security while the other two factors indicated otherwise. Nowhere in *Reves* does the Supreme Court set forth the relative weight to be given each of the four factors. It is unclear whether one factor can lead to adding an instrument to the list of non-securities if the other factors point in the opposite direction. The practicing lawyer and judge are left with very little guidance when confronted with a close case.

*John Scribner*